



June 15, 2007

Linda Adams, Secretary
California Environmental Protection Agency
1001 I Street
Sacramento, CA 95812

Winston Hickox, Chair
California Market Advisory Committee
1001 I Street
Sacramento, CA 95812

RE: Comments on “Recommendations for Designing a Greenhouse Gas Cap-and-Trade System for California”

Secretary Adams, Chairman Hickox, and Members of the Committee:

We are writing to express our appreciation for your hard work in drafting the Market Advisory Committee (MAC) report, which provides valuable guidance on how a cap and trade program could be designed for California. We appreciate the effort, expertise, and thought that clearly went into the market design recommendations contained in this report. We also appreciate the opportunity to have our chief economist, Dan Dudek, participate on the MAC Committee.

As you know, AB 32 authorizes but does not require the California Air Resources Board (CARB) to implement a cap and trade program as part of the AB 32 implementation package. That decision is to be made by CARB as part of its work in developing and approving the scoping plan for the overall program, provided that certain tests set out by statute are met.¹ We believe that these tests can be met, and we believe that a market-based cap and trade program will prove to be an integral part of California’s overall strategy to meet the goals outlined in AB 32. At the same time, we also fully concur with the MAC recommendation that “there is a strong economic and public policy basis for other policies that can accompany an emissions trading system.”

Environmental Defense has extensive experience working on the design, development, and implementation of emission trading programs throughout the world, and this has shaped our views regarding many of these issues. The MAC report does a good job of highlighting those design features that are fundamental to any sound cap and trade program, such as maintaining the integrity of the cap and ensuring that the program is built upon a foundation of sound data and reporting, while at the same time providing a broad overview of design options for California decision makers as they evaluate a cap and trade program in light of its potential to achieve greenhouse gas emission reductions and to further other important state policy goals. We look

¹ See *Assembly Bill 32, California Global Warming Solutions Act of 2006*

forward working with members of this committee, the Air Resources Board, Cal EPA, the Public Utilities Commission, the Energy Commission and other interested stakeholders on this issue.

Please find below some specific comments on a number of the issues addressed in the MAC report.

1. Program Scope

We concur with the MAC recommendation that broad programmatic coverage is desirable. As the report notes, broad coverage creates greater opportunities for low-cost reductions and safeguards against the abuse of market power by individuals or small groups of entities. At the same time, in order to be effective, a cap and trade program must be built upon a solid foundation of accurate and adequate emissions monitoring, reporting, and enforcement. This basic infrastructure must be in place for a particular sector to be included within the cap and trade program. As the MAC recommends, the best approach may be to start with the broadest coverage possible consistent with that requirement and to phase in additional sectors over time.

2. Offsets

Offsets help to facilitate lower cost emission reductions and encourage entities or sectors outside of the cap to undertake activities to reduce emissions, ultimately allowing for more emissions reductions to occur in a faster time frame than would be possible without offsets. Thus, we concur with the MAC recommendation that offsets should be allowed as part of the overall cap and trade program. We do not think that offsets should be limited in quantity, or in geographic scope so long as the integrity of monitoring, verification and enforcement can be assured. Criteria must be developed to ensure that emission reductions from offsets are real, verifiable, quantifiable, measurable, enforceable, and additional. Environmental Defense takes very seriously the need to ensure that offsets meet these criteria.

Of special note is the potential for the Clean Development Mechanism (CDM) established under the Kyoto Protocol to play a role in California's program. As discussions move forward on a post-2012 regime for international cooperation on GHG control, we note the increasing importance of developing countries in the future evolution of the atmosphere. At the same time, we are very aware of recent criticisms of CDM, and believe that a review of the reliability and enforceability of credits obtained through the CDM mechanism is necessary prior to any move to accept such credits into California's market. A discounted "trading ratio" should be applied in order to ensure that such reductions do not simply shift business-as-usual increases from one location to another, but contribute to real global reductions. We look forward to working with CARB to find ways in which incentives for fuller participation by the large emitting developing nations can be established as part of California's cap and trade program.²

3. Safety Valve

We strongly concur with the MAC recommendation that a safety valve should not be included as part of the cap and trade program. A fundamental feature of a cap and trade program is the ability to guarantee environmental performance through a hard cap on emissions. A safety valve

² See Attachment entitled: *Summary of Testimony of Annie Petsonk, International Counsel, Environmental Defense, before the Subcommittee on Energy and Air Quality, Committee on Energy and Commerce, United States House of Representatives, March 27, 2007*

would directly undermine the effectiveness of the cap, which would fatally undermine the environmental integrity of the program. Depending upon the level set, a safety valve is *de facto* a carbon tax. *Moreover*, as the MAC report notes, linkage with other emission trading programs would be seriously hampered, if not rendered impossible, by the existence of a safety valve.

4. Air Quality and Environmental Justice Considerations

AB 32 contains groundbreaking air quality and environmental justice safeguards, including a requirement that “activities undertaken to comply with the regulations do not disproportionately impact low-income communities” and that such “activities complement, and do not interfere with, efforts to achieve and maintain” air quality and toxic emission reduction goals. We appreciate and support the MAC recognition that any cap and trade program must address these concerns. We believe that a well-designed cap and trade program will provide tremendous environmental and public health benefits that go along with greenhouse gas emission reductions. However, reinforcing the need for compliance with existing air quality programs and anti-backsliding regulations would provide welcome support to the program.

5. Electric Sector Design

California’s electric sector accounts for over 20% of the state’s CO₂ emissions. And, because a significant portion of these emissions come from out of state generation, there are unique challenges related to designing an effective cap and trade framework for this sector. As the MAC points out, minimizing “leakage” and ensuring effective emissions tracking and accounting are key concerns that must be addressed. We strongly agree. Additionally, we believe that the rules for the electricity sector should be designed in a way that enables it to fit in as seamlessly as possible with the state’s overall cap and trade program. Environmental Defense has and will continue to participate in the ongoing proceeding at the Public Utilities Commission and the California Energy Commission aimed at developing recommendations that CARB can use to secure the necessary emission reductions from the electric sector.

6. General Design Considerations & Administrative Issues

We support the four overarching “general design considerations” outlined in the MAC report. As noted, environmental integrity, cost-effectiveness, fairness, and simplicity are objectives that any cap and trade program in California should strive to meet. In addition to these general principles, we also agree with and appreciate the MAC’s recognition of the importance of basic administrative principles such as monitoring, reporting, and enforcement as integral to the integrity of any cap and trade program. Ensuring that these features are properly designed and operating before the commencement of trading will be crucial to the success of the program.

7. Linkages

Environmental Defense strongly advocates that the California market system be designed to be capable of linking with other such programs in the United States and internationally. We agree with the MAC’s comments that “linkages can increase market liquidity, cost-effectiveness and functionality.” Our preference would be to link with other mandatory capped systems with comparable or greater stringency in order to avoid diluting the net reductions from the state’s program. California may also consider recognizing reductions earned below a national historical baseline in the context of tropical deforestation, which contributes roughly as much CO₂

emissions as the entire United States.³ It is critical to periodically review linking agreements to ensure that other program changes are not interfering with the attainment of California's program goals.

8. Allocation

Environmental Defense appreciates the committee's thoughtful discussion of the options for allowance distribution. We believe the ultimate decision of how to distribute emissions allowances is properly laid in the hands of California decision makers, and we believe that the MAC report contains valuable perspectives for Californians as they consider this fundamental design question. Environmental Defense supports efficient and equitable allowance distribution methods that reward early actors and are aimed at reducing greenhouse gas emissions. We agree that the program should ultimately work towards a very significant percentage of auctioning of allowances.

Again, we thank the MAC for its efforts on this critically important issue and appreciate the opportunity to offer comments on this draft. We look forward to a continued dialogue on these issues as we all work toward developing the most effective approach for California in addressing the threat of global warming.

Sincerely,

Karen Douglas
California Legislative Director

³ See Attachment entitled: *Summary of Testimony of Annie Petsonk, International Counsel, Environmental Defense, before the Subcommittee on Energy and Air Quality, Committee on Energy and Commerce, United States House of Representatives, March 27, 2007*